

MATERIALITY
RELIANCE ON PROFESSIONALS
OPEB DISCLOSURE

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MATERIALITY

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BASIC TEST

- **Focus on “reasonable” investor**
- **Substantial likelihood investor would consider information important in making decision**
- **Substantial likelihood that viewed as having significantly altered “total mix” of information**

MATERIALITY

DC COURT OF APPEALS

- ***Each investor***
- **Many types of “reasonable” investors**
 - **Singular, idiosyncratic preference for balancing risk & return in unique portfolio**
- **Different investors make very different decisions**

MATERIALITY

DC COURT OF APPEALS

- **Not majority investor vote**
 - **“Singular” investor needs**
- **Long-term vs. short-term**
- **Risk averse vs. speculative**

RELIANCE ON PROFESSIONALS

RELIANCE TEST

- **Complete disclosure to professional**
- **Sought advice as to appropriateness of challenged action**
- **Received advice conduct was appropriate**
- **Relied on advice in good faith**

RELIANCE ON PROFESSIONALS

If want to establish reliance—

- **Formal written opinion**
- **Qualified professional**
- **Make complete disclosure**
- **Review carefully**
- **Certifications of experts**

SAN DIEGO & OPEB DISCLOSURE

SAN DIEGO ENFORCEMENT ACTIONS

OPEB DISCLOSURE ISSUES

- **City**
- **City Auditor & Individual Principal**
- **Former City Officials**

SAN DIEGO ENFORCEMENT ACTIONS

OPEB DISCLOSURE ISSUES

- **OS Disclosure—Both Text & Financial Statement Notes**
- **Continuing (Annual) Disclosure—Financial Statement Notes Again**
- **Rating Agency Presentations—Indirect Disclosure to Investors & Market**

SAN DIEGO ENFORCEMENT ACTIONS

CITY SETTLED

- **Cease & Desist Order**
- **Agreed to Employ Independent Consultant to Review & Recommend Improvements in Practices**

SAN DIEGO ENFORCEMENT ACTIONS

CITY ACTIONS

- **Also Conducted Extensive & Expensive Internal Investigations**
- **Left with Problem of Paying OPEB Costs**

SAN DIEGO ENFORCEMENT ACTIONS

AUDITOR SETTLED

- **Permanent Injunctions**
- **Individual Paid \$15,000 Civil Penalty**
- **SEC Challenged Auditor's Qualifications, Investigation & Knowledge of City**

SAN DIEGO ENFORCEMENT ACTIONS

AUDITOR SETTLED

- **Said Auditor Did Not Know Issues Associated with Payment of Retiree Health Costs**
- **Also Criticized Auditor's Consent without Adequate "Subsequent Events" Review of Changes in Liabilities**

Query—What About Clearing with Actuary Himself Statements in Financial Statement Notes About Actuary's Viewpoint?

SAN DIEGO ENFORCEMENT ACTIONS

AUDITOR CONSENTS

- **Not Just a Formality**
- **Important for Reliance on Auditor's Work**
- **Subsequent Events Review—Key Part of Process**

SAN DIEGO ENFORCEMENT ACTIONS

AUDITOR CONSENTS

- **Should Have Discovered Increasing Costs After Date of Audit**
- **Minor Cost—If Done Properly, Could Have Prevented Much Cost and Disruption**

SAN DIEGO ENFORCEMENT ACTIONS

FORMER CITY OFFICIALS

- **City Manager**
- **City Auditor-Comptroller**
- **Deputy City Manager for Finance**
- **Assistant City Auditor-Comptroller**
- **City Treasurer**

SAN DIEGO ENFORCEMENT ACTIONS FORMER CITY OFFICIALS

Penalties Sought

- **Declaratory Relief**
- **Permanent Injunctions**
- **Monetary Civil Penalties**

SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS

Extensive Allegations

Manager's Proposals 1 & 2 –Agreements with Unions

Led to Sustained Underfunding

SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS

SEC Often Looks at Conflicts

**References to Failure to Disclose One Official's
Conflicted Votes for Underfunding as Plan Trustee**

Also to Defendants' Interests in City Benefits

SAN DIEGO ENFORCEMENT ACTIONS **FORMER CITY OFFICIALS**

Three Important Concepts Cited

- **Funded Ratio**—Ratio of Assets to Liabilities
- **Unfunded Liability**—Dollar Shortfall
Between Assets & Liabilities
- **Net Pension Obligation (NPO)**—Cumulative Difference
Between City's Contributions & GASB Requirements

**SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS—**

Allegations

**Financial Statements Said
Actuary Approved of Funding Method**

SEC Says Not True Once Funded Ratio Fell Below 82.3%

SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS

Changing & Stale Information

2002 Financial Statements Reported
\$39.2 MM NPO,
But City Knew 2003 Would Be \$51.9 MM

**SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS**

Estimate

**Estimated PV of Retiree Health Care Liability
\$1.1 Billion**

SAN DIEGO ENFORCEMENT ACTIONS FORMER CITY OFFICIALS

Predictive or Probability Information

“City was aware that the CERS funded ratio would likely fall below [82.3% funded ratio] trigger level”

**[Trigger in Manager’s Proposal 1
Required Additional City Contributions]**

SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS

Expectation for Future Event

**Retiree Health Care Paid in Past from “Surplus Earnings”
in Pension Fund**

**Would Have To Be Paid in Future from
Direct City Payments**

SAN DIEGO ENFORCEMENT ACTIONS FORMER CITY OFFICIALS

Expectation for Future Event

City's "Looming Financial Crisis"

**Unfunded Liability Expected To Increase Dramatically
from \$720 MM in 2003 to \$2B in 2009**

**Estimated Annual Pension Contribution
Would Grow from \$51 MM in 2002
to \$248 MM in 2009**

SAN DIEGO ENFORCEMENT ACTIONS
FORMER CITY OFFICIALS

NOTE—

In Each Case, SEC Asks for
Disclosure of Present State of Knowledge

Estimates, Expectations, Probabilities

Uncertainties Also Should Be Disclosed

Requires Care to Frame Information

THE END